DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

Date: FEB 3 2000

Contact Person:
[redacted]
ID Number:
[redacted]
Telephone Number:
[redacted]

[redacted]

Employer Identification Number: [redacted]

Dear Applicant:

We have considered your application for recognition of exemption from federal income tax under section 501(a) of the Internal Revenue Code as an organization described in section 501(c)(7). Based on the information submitted, we have concluded that you do not qualify for exemption under that section. The basis for our conclusion is set forth below.

The question of whether you might qualify for exemption under section 501(c)(7) of the Code arose during a conference of right regarding an earlier application for exemption as an organization described in section 501(c)(6). As a result of that discussion, you submitted a new Form 1024 requesting recognition of exemption as an organization described in section 501(c)(7). As part of your application, you requested and we agreed, to transfer the information contained in the administrative record of your previous applications to this application so that the information would not have to be duplicated.

Our records show that you first applied for recognition of tax exemption under section 501(c)(6) in [redacted]. On [redacted] a proposed denial of exemption under that section was issued. The proposed denial was affirmed after a conference of right and finalized by letter dated [redacted]. We considered a second application for recognition of tax exemption under section 501(c)(6) submitted on [redacted]. A proposed denial of exemption was issued on [redacted]. This position was affirmed and finalized by letter dated [redacted]. It was during the conference of right regarding this application that the question arose as to whether you might qualify for exemption under section 501(c)(7).

The facts regarding your formation and operations were set forth in the previous proposed denials and are repeated herein as they pertain to this current application.

You were formed and operated as an unincorporated association prior to your incorporation on [redacted] under the laws of the State of [redacted]. Your

[redacted]

Articles of Incorporation state that you were formed as a business league for those individuals known as [redacted] of [redacted] and to serve as an organization for the dissemination and sharing of information among such [redacted], to educate such [redacted] regarding national and international activities and business arrangements among such [redacted] and to provide a coordination of strategy concerning the legal defense and protection of such [redacted] personal assets from those who wrongly attempt to attach such assets. The "[redacted] are a group of United States citizens who purchased membership interests in [redacted] insurance syndicates and were called upon to pay losses incurred by the syndicates.

Your bylaws initially provided that any person dedicated to your purposes and being a current or former [redacted] was eligible for voting membership, and that any interested person or entity that shared the same goals and interests was eligible for Associate Membership but not voting membership. Your bylaws state further that your voting members have the right to vote on the election of directors, on the disposition of all or substantially all of your assets, on any merger and its principal terms and any amendment of those terms, and on any election to dissolve the corporation. If you dissolve, the voting members receive a pro rata distribution of all assets, exclusive of those held in charitable trusts, remaining after payment or provision for payment of your obligations and debts and provision for any other payment required under applicable law. No membership or right arising from such membership is transferable. In addition, such rights do not cease on a member's death, but continue for the benefit of the member's estate. Your bylaws were later amended to provide that any interested person could become a voting member so long as they paid the full membership fee irrespective of whether such person was a [redacted]

In an editorial in your [redacted] Newsletter, you stated that most [redacted] were targeted by the insiders at [redacted] to absorb their (the insider's) coming unquantifiable losses, and that this fraud committed against [redacted] would require [redacted] to take defensive action. You also asked that each one of your member [redacted] send in the General Undertaking documents and subsequent documents which they signed together with any relevant correspondence for study by your attorneys.

Your [redacted] Newsletter Heading reads as follows:

Statement of Purpose

The [redacted] is a defense grouping formed to protect [redacted] of [redacted] from unfair writs and other unjust legal actions brought against them in both [redacted] and [redacted]

In all cases where fraud, negligence, breach of proper duty of care, breach of the "utmost good faith" doctrine, or failure to properly regulate is proved against Lloyd's and where misrepresentation of risks and other crippling aspects

[redacted]

of membership were not properly disclosed as required by law, the [redacted] stands not only for rescission of the contracts between [redacted] and [redacted] but also the return of monies wrongly billed and wrongly collected.

This Newsletter contains several articles including "A Legal Overview" discussing the litigation taking place in [redacted] and [redacted] describing the litigation taking place in [redacted] in which more than [redacted] have joined suit to have their [redacted] contracts rescinded. This article states on page 5 "[redacted] which is organizing the lawsuit, has retained a top corporate counsel with Supreme Court experience to bring the case before a Federal District Court in [redacted]." A box on page 21 of the Newsletter indicates that the [redacted] has filed this suit. A box on page 22, headed HOW TO GO TO WORK ON YOUR OWN BEHALF, states as follows:

> In order to pursue the various legal actions which we have instigated on your behalf, we urgently need certain documents and information that [redacted] and your Members Agent gave to you prior to joining [redacted] (list follows).....without your spending an hour or so pulling these from your files, xeroxing the material and sending it to us by overnight service, it will be impossible for the [redacted] to properly represent you."

A box on page 2 of the [redacted] Newsletter lists Services Provided as follows:

[redacted]

Regular Membership:

Bank Notification for those who still have letters of credit notifying banks not to pay down on the letters of credit because of clear evidence of fraud.

Bank Notification in the event the bank does pay down that it does so at its own risk and may be liable to the [redacted]

Notifications are from our attorneys and are periodically updated to include the latest evidence and events leading to the expected final refusal of all the banks to pay out further monies.

Defense of both [redacted] and [redacted] who have already received writs and who are defending on the basis of fraud.

Services include, as well, the receipt of any writs filed on the [redacted] member by [redacted] and the appearance defending that writ, on behalf of the [redacted] All of this is provided at no extra charge to the individual [redacted]

Associate Membership:

[redacted]

For [redacted] who do not wish to have their banks notified, and who do not wish to defend the writ in [redacted], but who do wish to support the activities of the [redacted] and who reserve the right, at a later date, to establish a Regular Membership at the full going rate of $[redacted] or more at the time they join. Associate Members are also eligible for participation in the [redacted] lawsuits.

[redacted]

Members of the [redacted] are participating in the lawsuit against [redacted] in the United States, charging [redacted] with fraud, and possibly, suing other parties as well.

Your [redacted] Newsletter contains an explanation of the litigation to be undertaken in [redacted] According to the lead article, you created the [redacted] as a separate division of the [redacted] which present and future members may join on a voluntary basis. The [redacted] has a separate [redacted] action litigation committee appointed by your board of directors to manage the anticipated large multi-party U.S. action, and a separate litigation fund established through [redacted] membership contributions, for financing the action. The [redacted] is not separately incorporated. It is an operating division of your organization.

Participation in the American lawsuit (and membership in the [redacted]) is available only to your members. They must pay the [redacted] dues of $[redacted] to become a full member, giving them a legal defense against writs in [redacted] or $[redacted] to become an Associate Member, which gives no protection against writs, before paying the additional contribution to join the [redacted] to participate in the U.S. Action sponsored by the [redacted]

In your letter of [redacted] you refuted the implication that you provided individual services to your members by explaining that you take no action to safeguard the individual's assets or provide an individual legal defense. You indicated that any of your members who wished individual legal services to protect their own assets must make individual arrangements with your attorneys and pay their own legal bills. You indicated that your funds had been used only to assist with the defense of [redacted] in [redacted] who are not your members. In your letter of [redacted] you stated that your "legal activities have been significant and incurred to encourage honesty and full disclosure by huge insurance corporations when dealing with individual [redacted] This is accomplished by supporting litigation which in effect makes an example of the size of opposition a large company ...may meet when not dealing fairly and honestly with individuals." We believe your argument at that time was that by funding the ongoing litigation, you were serving to improve the business environment for all [redacted] acting as individual reinsurance companies for [redacted] including your members.

Your [redacted] application requested reconsideration of your earlier application indicating that the organization's prior Counsel did not adequately present the facts or accurately

[redacted]

describe the law as it relates to section 501(c)(6) organizations. In this application, you endeavored to explain further some of the facts recited in your earlier application and forming the basis for the [redacted] affirmation of denial.

On page 6 of your [redacted] resubmission letter, you state, through your Counsel, that your primary activity is the gathering and dissemination of information related to the common business interests of [redacted] You indicated that although certain [redacted] are engaged in a variety of lawsuits against [redacted] you are not a party to those actions. No one is required to engage in any litigation to become or remain a member. You endeavor to provide information of general interest to your members as well as information concerning these on-going lawsuits against [redacted]

In response to the allegation in our earlier proposed denial that you provide legal services to your members, you indicated that your involvement in such suits is minimal. You further state that you established the [redacted] to handle specific legal services on behalf of certain individual [redacted] Not all [redacted] are plaintiffs in individual suits; only those that are in litigation are members of the [redacted] You indicated that the [redacted] is a small part of your activities and is not your primary activity on an income or time allocation basis. You also stated that you serve as a trustee over certain funds (the "Litigation Fund") used to pay for legal services. You established the Litigation Fund based on the need of member [redacted] to have a central repository for the collection and expenditure of litigation expenses. You describe your role in connection with these funds as a conduit. You receive payments specifically identified as being for the Litigation Fund and disburse the amounts to the independent attorneys rendering services upon the advice of the Litigation Fund Committee. As pointed out by your Counsel on page 14 of the [redacted] letter, the [redacted] Committee and the Litigation Fund are arguably a particular service to your members.

Your [redacted] application for exemption under section 501(c)(7) did not set forth any new facts although you provided further characterization of some of your activities. You indicated, in a letter dated [redacted] that your primary purpose is to serve as a focal point for the Names to gather, to share and to disseminate information relating to their common interests. You indicated that you serve as a type of support group for your members, all of whom have suffered through unfortunate common experiences with [redacted] You state that your regional and annual meetings, as well as conference calls, make it possible to build and maintain the social relationships among Names that are vital to their emotional and psychological well-being. This frequent interaction allows your members to compare experiences on an array of issues, including the psychological effects of being victims of fraud. Your periodic newsletter keeps your members informed between meetings. The information gathered and disseminated in these newsletters includes information of general interest to [redacted] as well as information concerning the on-going lawsuits against [redacted]

[redacted]

Your [redacted] letter reiterates that you are not a party plaintiff in any of the legal actions and states further that you do not participate in these actions nor provide legal advice. Notwithstanding these assertions, however, you also reaffirm the fact that you established the [redacted] and it operates as part of your organization. The [redacted] "Litigation Committee," with the approval of your board of directors, has hired attorneys who act for the individual plaintiffs and has the authority to make decisions on the participating individual plaintiffs' behalf. You also affirm your earlier submissions indicating that you act as a conduit holder of certain "Litigation Funds" contributed by member-Names to be used for the payment of legal services provided by outside counsel.

Section 501(c)(7) of the Code provides for the exemption from federal income tax for clubs organized for pleasure, recreation and other nonprofitable purposes, substantially all of the activities of which are for such purposes and no part of the net earnings of which inure to the benefit of any private shareholder. This section was amended in 1976 to substitute the "substantially all" test for an "exclusively" test with respect to the extent to which a social club must be operated for exempt purposes. Regulations to accompany this amendment have not yet been issued.

Prior to the 1976 amendment, there were three primary problems affecting the tax status of social clubs: (1) income from the use of a social club's facilities or services by the general public; (2) income from club-held investments; and (3) to a lesser extent, income from the conduct of unrelated activities that did not further exempt purposes whether conducted with members or nonmembers. It is this third issue with which we are now concerned.

The Service has historically taken a conservative view of activities undertaken by a club that are outside the scope of social club purposes. Thus, the pre-1976 regulations accompanying section 501(c)(7) provided that a club which engaged in business was not organized and operated exclusively for nonprofitable purposes and, therefore, was not exempt. [Reg. 1.501(c)(7)-1(b)] The conduct of such an activity, whether with members only or with the general public, if it was not incidental to or in furtherance of any purpose for which exemption is granted under section 501(c)(7), was grounds for denial of exemption, regardless of how much income was generated from the activity. Thus, any amount of nonexempt social club activity (subject to an insubstantial, trivial, and nonrecurrent test) gave rise to revocation of exemption. For example, in Rev. Rul. 68-168, 1968-1 C.B. 269, the club's engagement in the business of long-term real estate rentals caused the loss of exemption. Santa Barbara Club v. Commissioner, 68 T.C. 200 (May 23, 1977) and Rev. Rul. 68-535, 1968-2 C.B. 219, support the loss of exemption for clubs engaging in the sale of packaged liquor to members for consumption off-premises.

The 1976 amendment of section 501(c)(7) was intended to address only the first two problems - nonmembership use of club facilities and investment income. It was anticipated that the IRS would continue to address the problem of unrelated activities as it had in the past. The congressional committees concerned with this legislation set forth their

[redacted]

understanding of how the law is to be applied. Both the Senate and House Committee Reports characterized the change as "twofold" and explained its effect on existing law:

> First, it is intended to make it clear that these organizations may receive some outside income, including investment income, without losing their exempt status.
>
> Second, it is intended that a social club be permitted to derive a somewhat higher level of income than was previously allowed from the use of its facilities or services by nonmembers without the club losing its exempt status. *The decision in each case as to whether substantially all of the organization's activities are related to its exempt purposes is to continue to be based on all the facts and circumstances.* [Emphasis added.]
>
> S. Rept. No. 94-1318 (1976), 2d. Sess., 1976-2 C.B. 597, 599; See also, H. Rept. No. 94-1353, to accompany H.R. 1144 (Pub. L. 94-568, 4 (1976).

Thus, it seems clear that Congress merely intended to clarify existing law:

> [T]he committee's bill clarifies existing law to permit somewhat larger amounts of income to be derived by exempt social clubs from nonmembers and also from investment income sources...
>
> The amendment as to income from nonmembers and investment sources...are intended as clarifications of existing law under the Tax Reform Act of 1969.
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> S. Rept. No. 94-1318 (1976), 2d. Sess., 1976-2 C.B. 597, 598, 601; H. Rept. No. 94-1353, to accompany H.R. 1144 (Pub. L. 94-568, 3-4, 8 (1976).

The Reports explain that a club is permitted to receive 35 percent of its gross receipts, including investment income, from outside sources, with no more than 15 percent of such gross receipts derived from use of a social club's facilities or services by the general public. In explaining the 15 percent limitation, the Reports state that the effect is to increase from "5 percent (current audit standard: Rev. Proc. 71-17) [1971-1 C.B. 683] to 15 percent the proportion of gross receipts a club may receive from making its club facilities available to the general public without losing its exempt status."

The House Report also states on page 4:

> Your committee does not intend that these organizations should be permitted to receive, within the 15 or 35 percent allowances, income from the active conduct of businesses not traditionally carried on by these organizations.

[redacted]

Earlier legislation also supports a prohibition against the conduct of businesses that do not serve exempt purposes. The Tax Reform Act of 1969 (Pub. L. 91-172, 83 Stat. 487) subjected social clubs to the tax on unrelated business income for taxable years beginning after December 31, 1969. Both legislative committees stated, in the course of considering the applicable legislation, however, that it was not their intention to change the test for determining whether nonexempt activities were sufficient to require that the social club should lose its exemption. S. Rept. No. 91-552 (1969), 1969-3 C.B. 423, 471; Conf. Rept. No. 91-782 (1969), 1969-3 C.B. 644, 652.

Based on the foregoing legislative history, it is clear that Congress intended to distinguish between traditional business activities and nontraditional activities. Traditional business activities are subject to a 15 percent rather than a 5 percent limitation for businesses conducted with nonmembers. Nontraditional business activities continue to be prohibited (subject to an insubstantial, trivial, and nonrecurrent test) for businesses conducted with both members and nonmembers.

Activities that are not "normal and usual activities" of a social club are considered nontraditional activities. For the purpose of defining what are "normal and usual activities" of a social club, it is helpful to refer to Rev. Proc. 71-17, as the Committee Reports indicate Congress did in defining gross receipts for purposes of the 15 percent limitation. In that revenue procedure "normal and usual activities" encompasses those social and recreational activities upon which the club's exemption is based. Extension of these traditionally exempt social club activities to the general public gave rise to unrelated business income; they resulted in revocation of exemption only if the 5 percent limitation (now 15 percent) was exceeded (and, additionally, if a facts and circumstances test was not satisfied).

The Committee Reports incorporate this view and note that the 15 and 35 percent limitation do not include "income from the active conduct of business not traditionally carried on by [section 501(c)(7)] organizations." The definition of "nontraditional business activities" is the same as it was prior to 1976 and is premised on Congressional intent to retain existing law with respect to the definition of the term "normal and usual activities." A prohibited nontraditional business does not further the exempt purpose of the organization even if conducted solely on a membership basis. For example, the sale of liquor to members for consumption off the club's premises is a nontraditional business activity and precludes exemption. See, Santa Barbara Club v. Commissioner, supra; and Rev. Rul. 68-535, supra.

In determining whether an organization qualifies for exemption under section 501(c)(7) of the Code, we must first determine that it is organized for pleasure, recreation, or other nonprofitable purposes. Then each activity must be tested to determine if it furthers pleasure, recreation, and other nonprofitable purposes or is a nontraditional activity that precludes exemption.

[redacted]

In your latest submission, you state that your primary purpose is to serve as a focal point for the [redacted] to gather, to share and to disseminate information relating to their common interests. You compare your activities to a type of support group for your members, all of whom have suffered through unfortunate common experiences with [redacted] In telephone conversations, your representative has compared you to a type of investment club as well. You state that your regional and annual meetings, as well as conference calls and the like, are a frame on which to build and maintain the social relationships among the [redacted] that are vital to their emotional and psychological well-being.

Although one purpose served by your organization's activities may be to further social interaction among [redacted] within the meaning of section 501(c)(7), a review of your history as reflected in your Charter, bylaws, newsletters and previous submissions leads us to conclude that any social or recreational purpose is clearly subservient to your business purposes. Your Charter states that you were created as a business league for [redacted] to disseminate information among them, to educate them regarding national and international activities and business arrangements, and to provide a coordinated strategy concerning the legal defense of such [redacted] personal assets. The addenda of the regional and annual meetings as well as the newsletters you submitted show that these activities are used primarily to keep [redacted] informed of the various lawsuits against [redacted] and the various avenues being taken to defend against writs issued by [redacted] The primary purpose served by your club appears to be helping [redacted] protect their money and avoid bankruptcy. As stated in our [redacted] letter, the facts submitted support the view that your primary activity is to preserve the personal financial integrity of your individual members, even to the extent of providing legal assistance. Accordingly, we conclude that you are not organized for pleasure, recreation, or other nonprofitable purposes.

In addition, you are precluded from exemption under section 501(c)(7) because you have substantial activities which are nontraditional activities. According to your [redacted] Newsletter, full dues-paying members in your organization are entitled to a full legal defense against writs in [redacted] You provide the legal and technical support for these services at no extra charge to the individual [redacted] Associate members do not receive this protection against writs but may upgrade to full membership when they are served with a writ or other demand for payment on their contract is demanded by [redacted] These legal services are by no means insubstantial, trivial, or nonrecurrent and further no social, recreational or any other purpose that is within the purview of section 501(c)(7).

You have also created the [redacted] as a separate litigation committee to pursue a lawsuit in the United States on behalf of your members. Your board of directors has hired an attorney to pursue this lawsuit in [redacted] on behalf of individual litigants. Your members may participate in this litigation by contacting your attorney and paying their share of the legal expenses. You are not a party plaintiff to this litigation but there is no question that the [redacted] activities are your activities. In addition, you maintain a Litigation

Fund for the convenience of your members. This is a central repository for the collection and expenditure of litigation expenses that enables your members to shield their assets from other creditors while reserving such funds for the purpose of pursuing the lawsuit. You describe your role in this fund as a conduit but it is still a particular service to your members that is commercial in nature and serves no social, recreational or any other purpose within the meaning of section 501(c)(7).

Lastly, section 501(c)(7) has an inurement provision. The Litigation Fund raises the possibility of individual members' funds earning interest prior to being spent. We are unable to conclude that these amounts, when spent on behalf of the individual litigants will not result in inurement.

In [redacted] we spoke with your representative regarding whether you might qualify for exemption under section 501(c)(7) if you disassociated with the [redacted] and ceased serving as a conduit for legal fees for your members. You have not agreed to do so but we have reconsidered whether eliminating these nontraditional activities would be sufficient to establish exemption under section 501(c)(7). Because you would continue to be organized for purposes that are outside of those permissible under section 501(c)(7) and would continue the nontraditional activity of representing your members' interests in [redacted] exemption would still be precluded.

Accordingly, you do not qualify for exemption as an organization described in section 501(c)(7) of the Code and you must file federal income tax returns on Form 1120.

You have the right to protest this ruling if you believe it is incorrect. To protest, you should submit a statement of your views to this office, with a full explanation of your reasoning. This statement, signed by one of your officers, must be submitted within 30 days from the date of this letter. You also have a right to a conference in this office after your statement is submitted. You must request the conference, if you want one, when you file your protest statement. If you are to be represented by someone who is not one of your officers, that person will need to file a proper power of attorney and otherwise qualify under our Conference and Practices Requirements.

If we do not hear from you within 30 days, this ruling will become final and a copy will be forwarded to the Ohio Tax Exempt and Government Entities (TE/GE) office. Thereafter, any questions about your federal income tax status should be directed to that office, either by calling 877-829-5500 (a toll free number) or sending correspondence to: Internal Revenue Service, TE/GE Customer Service, P.O. Box 2508, Cincinnati, OH 45201. The appropriate State Officials will be notified of this action in accordance with Code section 6104(c).